

OPINION

Too Big to Fail and the Distortion of Compensation Incentives

BY JOHN A. WEINBERG

We sometimes think of compensation for employment as being a pretty straightforward thing — you get paid a fixed rate for the amount of time you work. But many jobs involve choices that the worker makes on a daily basis — choices that affect the outcomes achieved but are hard for the worker's boss to directly observe or influence.

For instance, it becomes difficult to simply say “you do X and I'll pay you Y” when X involves managing a portfolio of assets. How do you know if the assets have been effectively managed? Of course, you can look at the results achieved — for instance, the returns on investments — and compensate the manager based on those returns. But the results are likely to depend both on choices made by the portfolio manager and on random factors beyond the manager's control.

In general, you would like to be able to base compensation on an indicator of whether the manager made sound choices, but such indicators are hard to come by. After-the-fact indicators, like the actual portfolio performance, although imperfect, may often be the best you can hope for. By rewarding performance after the fact, a compensation arrangement faces the trade-off between giving the manager an incentive to make good decisions and exposing the manager to risks beyond his control — risks that make the job less desirable to begin with.

The trade-off between risks and incentives is the fundamental problem in designing compensation schemes in large organizations. The problem certainly arises in banks and other financial institutions, where pay policies have been argued to have increased incentives for taking large risks that contributed to the financial crisis. And in the wake of the crisis, efforts have begun, both in the United States and internationally, to increase the regulatory scrutiny of compensation practices in large banks. But what exactly is the problem that regulation needs to fix?

Designing compensation schemes is complicated, because of the difficulties in measuring performance and tying it to the actions of employees. But typically, a firm

that seeks to operate in the best interest of its shareholders has an incentive to create the best compensation scheme it can with the tools it has. What might get in the way of a firm's ability to strike the best possible balance between risk and incentives?

While the common narrative that many firms' pay practices gave executives an incentive to take excessive risks may have been true, it might not have been because compensation schemes were poorly aligned with shareholder interests. That is, it could have been the case that shareholders themselves had an inefficiently high appetite for risk-taking by large financial firms and that executive compensation was well-aligned with shareholders' distorted interests.

For financial firms, that distortion comes from the safety net provided by deposit insurance as well as the implicit subsidy that comes from some firms being viewed as too big to fail. These protections make creditors less concerned about the risks taken by a firm, resulting in lower costs of debt financing. And since shareholders benefit from higher returns, the safety net will tend to increase a leveraged financial firm's interest in taking risks. So absent regulatory or supervisory intervention, one might expect such firms to arrange their executives' compensation in ways that encourage, or at least do not discourage, risky decisions.

In the presence of a safety net that distorts financial institutions' incentives for risk, regulation needs to replace the discipline that would otherwise come from market forces. Whether that regulation is most effective when applied to compensation practices or more directly to the risk-taking activities of a firm is somewhat of an open question. But the effectiveness of either approach will be enhanced by a recognition that the fundamental source of incentive problems is not in compensation practices per se but in the protections of the financial safety net. **RF**

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John A. Weinberg is senior vice president and director of research at the Federal Reserve Bank of Richmond.